LISC
Helping neighbors build communities

Testimony of

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Housing Finance – What Should the New System Be Able to Do?

Government and Stakeholder Perspectives

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Introduction and Overview

Good morning, Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee. Thank you for the opportunity to testify regarding the functions and needs of the nation's housing finance system.

My name is Vincent O'Donnell. I serve as Vice President for Affordable Housing Preservation at the Local Initiatives Support Corporation (LISC), a national nonprofit intermediary dedicated to helping community residents transform distressed urban and rural neighborhoods into healthy and sustainable communities of choice and opportunity. In that position, I lead LISC's national efforts to support nonprofit rental housing preservation transactions; to build the capacity of nonprofit community development corporations (CDCs), residents, and state and local government; and to coordinate a variety of housing preservation policy activities, including helping to facilitate the National Preservation Working Group, a broad coalition of nonprofit, tenant and governmental preservation stakeholders. I speak today from the perspective of LISC as a whole, although I will address several issues specific to rental housing preservation within that scope.

Since 1980 LISC has worked in numerous partnerships involving banks and thrifts, CDCs, and government at all levels to revitalize urban and rural communities. LISC currently invests $600 million to $1 billion or more each year in these partnerships. Over time we have invested $9.6 billion, generating over $29 billion of development activity, including 253,000 affordable homes and 38 million feet of retail and community space. Most of this money has come from the private sector, including banks, Government-Sponsored Entities (GSEs) and insurance companies, mostly in the form of loans and investments.

Our work covers a comprehensive range of integrated activities that contribute to sustainable communities, including housing, economic development, building family wealth and incomes, education, and healthy lifestyles and environments. Our first name is Local, and we operate through 29 local offices and a national rural development program.

We have seen at close hand how the best and worst elements of the housing finance system affect low-income metropolitan and rural communities and their residents.

We have seen effective public private partnerships that have financed the production and preservation of about two million affordable rental homes in the last two decades. We also saw partnerships grow sustainable home ownership in the 1990s, fed by 30-year fixed-rate mortgages, prudent underwriting, and innovation. This work has improved life for millions of families and helped to revive urban and rural communities previously written off as beyond redemption. It also shows that private interests can serve public interests safely and profitably. Private participation leverages public resources and helps deploy them efficiently, effectively, and with a very high rate of success. These partnerships are neither spontaneous or lucky. They are the result of careful public policies that blended responsibility, opportunity, prudence, capacity, and accountability.

That said, we have also seen predatory lending ravage families and neighborhoods, fueled by flawed capital markets, mortgage products and underwriting and driven by players at multiple levels seeking a quick profit with no skin in the game and no effective regulation. We have also seen public policies that over-sell the genuine virtues of home ownership and ignore, neglect, or even denigrate the rental housing where one-third of American households live.

An important lesson is that the long-term interests of consumers and lenders, and of communities and the financial system, are and must fundamentally align rather than conflict. A loan that does not work for consumers and communities ultimately will not work for lenders and investors, or for the financial system and the economy. At the same time, failure to include all communities and their residents within the financial mainstream, consistent with safety and soundness – in short, a return to red-lining or the margins of our system – will only undermine opportunity and prosperity. In some cases, short-term expediencies have unfortunately overtaken long-term prudence. But this debate must not set up false dichotomies between insufficient and excessive lending. We and many others have worked collaboratively on a solid, common-sense middle ground.

In applying the lessons of the past to the challenges of today and tomorrow, we recommend two guiding principles:

(1) the housing finance system should be integrated in several dimensions, and

(2) private institutions that receive public benefits should also help to address public objectives.

We will develop these principles further below, but first it may be useful to set the context for our perspective.

Roles of CDFIs and Intermediaries

One of LISC's roles is that of a Community Development Financial Institution (CDFI). In that capacity, we make short- and intermediate-term loans and equity investments to benefit low-income people and communities. We do not, however, generally make long-term loans, but instead are interdependent with the institutional systems for housing finance. We also wish to stress that our interests extend beyond the specific activities we undertake. Because we work in economically distressed areas, the availability of mortgage financing in these areas sets the context of either vitality or disinvestment in which we operate. What we can do, how big a difference it can make, and its long-term success, all depend on this broader context.

We typically work with our community partners at the front end to identify unmet needs and then we invest in the solutions. The transactions themselves may involve production or preservation, and include both homeownership and rental housing. This support extends from an initial broad planning effort, through funding of predevelopment, to acquisition and construction financing for specific transactions, and often permanent equity investments in rental housing generating Low Income Housing Tax Credits.

In doing so, we both affect the housing finance market and depend on it. CDFIs such as LISC identify projects that often will not be done through market forces alone. In our work, we have found affordable housing finance is safe and profitable, but perhaps not the most profitable or easiest transactions available to the private market. One of our jobs is to make this socially beneficial enterprise attractive to institutional lenders and investors, often by intervening early in the process when risks are the greatest; by structuring complex financing including public programs; and by undertaking projects too small to attract private interest, especially at early stages. In that sense, we foster sound financing opportunities for the housing finance sector.

At the same time, our work requires the availability of permanent mortgage financing on reasonable and reliable terms. Basically, short-term sources of financing such as CDFIs will be reluctant to invest whenever permanent or construction financing is unavailable, unpredictable, too costly, or otherwise unworkable.

Historically, we have an excellent record of shepherding our scarce capital resources while supporting difficult, but socially valuable, transactions. However, in the last two years, changes in the housing finance environment, combined with long-standing structural issues with federal subsidies, have made our work dramatically more difficult. The result is that we are no longer able to invest as confidently in the very housing whose creation and preservation has become even more urgent.

One example of how this uncertainty affects the availability of debt and equity capital is Section 8 appropriations risk. Since 1997, when the Multifamily Assisted Housing Reform and Affordability Act of 1997 (MAHRA) was enacted, long-term fully-funded rental assistance contracts have been gradually converting to a status in which the available funds are annually appropriated. Over a period of more than a decade, in large part due to reliable and disciplined federal funding, capital markets have adjusted to this reality, requiring manageable discounts for the appropriations risk.

More recently, however, a combination of under-funding of project-based Section 8 contracts and more conservative investment standards has undermined this public-private bargain. The result is increased difficulty in obtaining permanent financing for properties that once were considered to be relatively good risks. Lower debt leverage and duplicative reserve requirements, for example, undermine the feasibility of valuable efforts to extend useful life of existing affordable housing. We are grateful that Congress has acted promptly and unequivocally to restore annual project-based Section 8 funding levels. While we are still working through the damage done by a breach of confidence at a particularly vulnerable time, I want to note some important and helpful government responses.

HUD Secretary Shaun Donovan has recognized the importance of aligning subsidy programs and financing sources in several ways. HUD has announced a Transforming Rental Assistance initiative, whose principles include streamlining and simplification, reliability of rental assistance, and market discipline. One of the initiative's major purposes is to increase transparency and the ability to leverage private capital. In addition, HUD has taken a number of concrete administrative steps to align FHA programs with the Low Income Housing Tax Credit and with the process of renewing Section 8 contracts and preserving assisted multifamily housing.

I also want to commend H.R. 4868, the Housing Preservation and Tenant Protection Act of 2010, which was filed last week by Chairman Frank and co-sponsored by many members of this committee. We are hopeful that a number of provisions in this bill, and in the Section Eight Voucher Reform Act, will improve the climate for permanent financing of affordable housing preservation transactions, on both the debt and the equity side.

Finally, we are enthusiastic about the new Capital Magnet Fund, through which the Treasury Department's CDFI Fund will position CDFIs and nonprofit housing developers to leverage private financing effectively.

An Integrated Housing Finance System

While the GSEs have been central to housing finance, we believe Congress should consider their future in the context of the broader housing finance system. We believe that system fragmentation has increased risk, created unlevel playing fields, reduced access to responsible credit, and thwarted efficiency. We do not presume that the GSEs, in their current form, are essential to a well-integrated housing finance system, provided that: (1) the system assumes the functions and capabilities that GSEs have developed; and (2) transitional challenges are addressed. However, before deciding on any structural issues, it will be important to be clear about the characteristics of the future system and then to consider what structures are most likely to meet these needs.

- <u>Primary and secondary markets.</u> It may seem obvious to coordinate the primary market where mortgages are originated on Main Street with the secondary market where mortgages are bought and traded on Wall Street. However, coordination has been incomplete in the past and could be either better or worse in a future system. A secondary market that accepted and even encouraged irresponsible subprime and nominal prime lending to homeowners, but would not support home rehabilitation or small rental properties, has not well served people, communities, the financial system, or the economy. Congress took a good step in 2008 when it aligned the GSEs' affordable housing goals more closely with banks' lending targets.

- <u>System-wide regulation.</u> While we support Congressional and Administration efforts to regulate the primary mortgage markets, it is equally important to regulate secondary markets as well. In housing finance, we have seen bad mortgage practice start in the unregulated segment and then migrate throughout the system, supplanting some safer practice and inflating housing price bubbles. The secondary markets are powerful drivers of the primary market. We have sometimes seen complex financial engineering in the credit markets mask and amplify risks instead of mitigate them, and then make fixing the resulting problems virtually impossible. The subprime mortgage crisis and the related difficulties of untangling several layers of mortgage-backed securities or modifying the mortgages are a painful example. Accordingly, we strongly urge regulation of all secondary mortgage market sponsors.

- <u>Both homeownership and rental housing.</u> While homeownership will understandably consume most of the debate, it is important to address the rental housing where about one-third of all American households live. The GSEs have played an increasingly important role in financing large-scale multifamily rental housing.

- However, the GSEs and unregulated secondary markets have poorly served the smaller rental buildings – including single family homes – where many renters live.

- Affordable rental housing has distinctly different risks compared to homeownership, in that it is often necessary to combine a variety of rental assistance subsidies with multiple sources of capital subsidy. Affordable housing preservation transactions, despite being generally immune to some development problems, such as zoning barriers, are especially challenging in this regard.

- Moreover, we have seen disturbing practices in multifamily housing finance, where some properties received mortgages much larger than rents can carry. This excessive leverage was based on unrealistic projections of rent increases that the market could not sustain, even if current tenants were displaced. Many of these mortgages are defaulting, and many have short terms that require impossible refinancing. For many of these properties, the market will not safely accomplish deleveraging. Recent experience indicates that, absent some intervention, owners will cut operations and maintenance expenditures in order to make interest payments, buildings will be capital starved, and mortgages may be sold at excessive prices. This phenomenon results in harm to buildings, neighborhoods and tenants. To the extent that banks are the lenders, these mortgages contribute to the commercial real estate mortgage problem that threatens many smaller and mid-sized banks, revealing the limits of prudential bank regulation. Moreover, consumer protection laws generally do not cover rental housing finance.

- <u>Both market-rate and affordable housing.</u> Some observers have suggested that the capital markets should address market-rate housing and that government programs, like the Federal Housing Administration or appropriated funds, should take full responsibility for affordable housing. We strongly support a vital FHA as well as federal appropriations, but assert just as strongly that low-income people need full and equitable access to mainstream capital markets. The FHA, historically, has not proven to be especially nimble or innovative, and its multifamily programs are often unresponsive to the needs of low-income communities, especially for smaller and mid-sized buildings. Serving affordable housing needs also requires:

  - coordination with public development subsidies, including LIHTCs;

  - support for and coordination with the CDFIs that have become integral to the development process; and

  - as noted earlier, the ability to accommodate federal rental assistance.

- <u>Both debt and equity.</u> While most of the debate will appropriately focus on mortgage financing, it will be important to consider the requirements and sources of equity as well. On the rental housing side, the GSEs provided about 40% of the LIHTC equity market, which has struggled since the GSEs withdrew from the market over two years ago. In financing affordable rental housing, LIHTC equity is often the largest source of permanent financing, and market-rate mortgage financing plays a lesser role. It will be appropriate for secondary market institutions to participate as LIHTC investors or as guarantors of investments, in addition to sources of debt capital. On the home ownership side, most first-time homebuyers cannot afford a 20 percent down payment plus closing costs. The GSEs, along with FHA, have played essential roles by offering prudent low-cash home purchase mortgage products. These products, perhaps combined with additional savings incentives like Individual Development Accounts, must remain a viable part of the housing finance system.

Meeting Public Policy Objectives

We believe it is both necessary and appropriate to expect private institutions that receive public benefits to address meet public policy objectives. The first of these public benefits is regulatory oversight, which we believe will greatly improve access to credit markets as well as reduce the cost of capital. In today's financial climate, two years after the collapse of Bear Stearns, there is still very little purely private mortgage capital available on a long-term basis. The great majority of long-term mortgage financing comes through the GSEs and FHA. The Federal Reserve has been supporting the GSE channel by purchasing mortgage backed securities, and is only now preparing to attempt to ease out of that role. The capital markets may not return to past vitality for several years, and even then may not be able to do what they used to do.

In addition to regulatory oversight, private institutions have benefited from FHA mortgage insurance, GNMA securities guarantees, and the GSEs' credit enhancements. While the federal role in mortgage markets may change, similar support should help justify private obligations to address the following public policy objectives.

- <u>Liquidity in all economic conditions</u>. The current financial and economic climate reinforces the core importance of providing liquidity in all economic conditions.

- <u>Long-term, fixed-rate mortgages for both homeowners and rental housing</u> remains important. The benefits for homeowners are well established. For rental housing, long-term fixed-rate financing allows a predictable payment stream – especially important to affordable housing and in stable and declining markets, where rents cannot be presumed to grow faster than operating expenses. It also reduces the likelihood of forced refinancing in difficult times, a problem we see now in both rental and owner-occupied housing. Many observers believe that federal credit enhancements on mortgage-backed securities will be necessary to providing long-term, fixed-rate mortgage products.

- <u>Capital access for all communities, including economically distressed, low-income, rural, and minority communities,</u> on a fair, equitable and sustainable basis will be essential to the economic and social viability of these communities. In particular, private institutions should partner with CDFIs to help deliver financing products and support housing production and preservation and other community development activities. For rental housing, we would also suggest that LIHTC equity investments be considered as a valuable form of financing, albeit in the form of an investment.

- A small millage fee to support the Housing Trust Fund and the Capital Magnet Fund. Congress already approved this policy approach with respect to Fannie Mae and Freddie Mac as part of the Housing and Economic Recovery Act of 2008. The principle should be affirmed and applied more broadly to secondary market institutions. Broadening the base would allow a lower millage rate to generate a given level of funding, and keep the playing field level for all institutions.

Conclusion

Chairman Frank and members of the committee, the decisions you make in reforming the housing finance system will have far-reaching consequences for all Americans and all communities, but for none more than low- and moderate-income families and communities. It would be a tragedy, and a travesty, if the same people and places that had worked so hard to improve their futures only to suffer irresponsible lending and the ensuing foreclosures and unemployment, were now locked out of the financial mainstream. That would hurt not just them, but all of us.